UNCTAD releases new Roadmap and Guide for debt workouts

By Bodo Ellmers

The prevention of debt crises and the way these crises are managed have a tendency to fail due to the lack of adequate institutions. While Europe is still struggling to solve the old debt crises, a new round of debt crises is emerging in developing countries, triggered by falling commodity prices and rising borrowing costs. Against this backdrop, an expert group convened by the United Nations Conference on Trade and Development (UNCTAD) has developed a detailed new Roadmap and Guide that aims to make future debt workouts fairer, more efficient and more sustainable. Launched at the UN in New York last week, an application of the Roadmap would revolutionalise the way debt crises are managed in future.

The right tool at the right time

The timing could not be better. Greece, strangled by austerity measures and the economic and humanitarian crises they have caused, is once again on the verge of bankruptcy, proving that the Troika bailout strategy failed and debt restructuring is the only solution. In fact, it had been the better solution from the very beginning of the crisis. The big UN Summit on Financing for Development (in Addis Ababa in July) and the Post-2015 Development Agenda (in New York in September) are both coming up, and sovereign debt workouts are fundamental pillars both of financing for development (FfD) and the sustainable development goals. Falling prices at the end of the commodities super-cycle might drive many developing countries back to bankruptcy, especially when interest rate levels begin to rise.

Gaping governance holes

The UNCTAD expert group has examined the shortcomings of the current multilateral debt (crises) management regime and found that it cannot work effectively because it is highly fragmented in different creditor-dominated forums such as the International Monetary Fund (IMF) and the Paris Club, none of which can guarantee a debt restructuring deal that covers the whole debt stock in a single comprehensive process. Debtors need to negotiate separately with different groups. The little by little debt restructurings that this system involves take a long time and lead to unfair outcomes, because all the creditor groups pursue their vested interests and push for better deals for themselves. Some hedge funds even made a lucrative business model out of sabotaging debt crisis management by fully refusing to negotiate and suing for full payment – the vulture funds. The current regime has no effective way of stopping the vultures and enforcing participation and fair burden sharing among creditors.

The new Sovereign Debt Workout Institution

Many of these problems could be overcome by creating a Sovereign Debt Workout Institution (DWI) as part of the multilateral system. This DWI would be impartial and transparent. It would be a place that debtor states can turn to when seeking a debt workout. Its role would be to facilitate an inclusive dialogue with the entirety of its creditors and other stakeholders, to mediate and to provide the technical and logistical support for sovereign debt workouts.

The UNCTAD Roadmap also suggests developing new early warning indicators and indicator benchmarks for sovereign debt. Such indicators would need to take the new sustainable development agenda and its financial implications for UN Member States into account. Last but not least, the Roadmap suggests that all UN Member States should adopt "specific legislation to protect the outcome of consensual negotiation processes", i.e. to avoid vulture funds lawsuit. The suggestion of creating public lists of uncooperative creditors and their parent companies also has the goal of stopping the vulture attacks.

The guidance to prevent debt crises

A key asset of the Guide is the suggestions to sovereign debtors. Similar to recent IMF proposals, UNCTAD suggests improving bond contracts by adding (single-tier aggregated) collective action clauses. The Guide goes beyond recent IMF proposals, however, when it also suggests clauses allowing for mediation and arbitration in a sovereign debt restructuring, a standstill of payments and a stay on litigation and enforcement. It also suggests setting up debt management offices and producing independent debt stability reports.

The Roadmap: 17 steps to debt workouts

The centrepiece of the new tool, however, is the debt workout Roadmap, which outlines a process involving 17 steps, from the trigger to the closure of a debt restructuring process. A key innovation of the UNCTAD proposal is that the process is largely driven by the debtor side, with the support of the independent DWI. This is designed to overcome the problem that debt restructurings currently come "too little – too late" because they depend on creditors, who tend to delay the process in the hope that better times will come, or that someone will let the bailout monies flow.

Based on thorough debt sustainability analyses that identify whether there is a solvency or just a liquidity problem, the debtor would invoke a debt standstill and – if needed – capital controls. It would invite creditors to an initial roundtable, which decides on modalities for negotiations. These could either be direct negotiations between debtor and creditors, or could be facilitated by a mediator or an arbitration panel. In any case, agreements will be binding on all parties, will include a verification of claims and the opportunity to question their validity, and will be based on an independent debt sustainability analysis. This analysis would also determine the size of haircuts and the economic and social recovery programme.

Big push or incremental implementation?

The full implementation or application of the new UNCTAD Guide and Roadmap now would revolutionise the way debt crises are managed. It would speed up their management, lead to fairer outcomes, and most importantly, reduce and mitigate the development damage they do. In many areas, the Guide and Roadmap contain options rather than clear guidance. This might make sense, however, as different debt crises vary from country to country, and a one-size-fits all approach is not always the best way to go, as also the poor outcomes of Paris Club restructurings have demonstrated.

The modular structure also allows for an incremental introduction of the many specific suggestions by policy-makers. The year 2015 is certainly not short of opportunities to do so, with the UN General Assembly process towards a multilateral framework for sovereign debt restructurings ongoing, and the Addis and New York Summits on the horizon.